Dean Bladen

SUBMISSION

TO THE

ROYAL COMMISSION ON BANKING AND FINANCE

MAY 1962

[Brief 48A]

E. P. NEUFELD

NOT FOR RELEASE UNTIL

12 A.M. THURSDAY

Oct 25
~~MAY 17~~, 1962

From:- Edward P. Neufeld,
Department of Political Economy,
University of Toronto,
Toronto, Ontario.

Honourable Dana Porter, L. L. D.,
Chairman, Royal Commission on Banking and Finance,
P. O. Box 1502,
Postal Station "B",
Ottawa, Ontario.

Dear Sir:

I am pleased to enclose my Submission to the Royal Commission on Banking and Finance. I include in this letter a brief summary of my views, recommendations and suggestions, all of which are submitted in my personal capacity. The writer appreciates the honour of being given an opportunity to present his views in this way.

The Submission is composed of two main parts, the first dealing with the problem of economic instability, the second with the functioning of the capital market. Recommendations are lengthy and so are not fully included in this outline.

PART ONE

THE PROBLEM OF ECONOMIC INSTABILITY

I. The Tasks of Economic Stabilization Policy

(1) Objectives

Only through the development and use of effective control techniques and through co-ordination of the various techniques will we eventually be able to determine what economic objectives can be achieved. With this in mind

the Government of Canada should establish an economic stabilization board or committee, composed of representatives of the various government departments and Bank of Canada, with a permanent Chairman and research staff and with specific tasks to perform.

In a general way it may be said that economic stabilization policy should have as its objective the achievement of a low level of unemployment, a high rate of economic growth, relative price stability, and an equitable distribution of the costs which are inflicted on individuals by any economic instability which it has not been possible to remove -- all within the framework of techniques which interfere as little as possible with the efficient functioning of the capital market.

(2) Nature of Canada's Economic Instability

and

(3) Specific Tasks of Stabilization Policy

The nature of Canada's economic instability is such that those responsible for implementing stabilization policy should regard themselves as being faced with the following tasks:

(a) to control cyclical spending in the private sector in general;

(b) to ensure that particular sectors do not become so volatile as to produce harmful economic distortions;

(c) to increase the mobility of labour and capital, particularly between the public and private sectors of the economy;

(d) to improve the flow of information to the private sector of the economy so as to reduce instability arising from business decisions based on incorrect or incomplete information;

(e) to deal specifically with "cost-push" inflation;

(f) to help ensure that the costs imposed on individuals by economic instability which it has not been possible to remove are borne equitably.

II. Techniques of Economic Stabilization

(1) Monetary policy, fiscal policy, and debt management have been less than adequately successful in the past because of insufficient co-ordination between them,

(a) to control cyclical spending in the private sector in general;

(b) to ensure that particular sectors do not become so volatile as to produce harmful economic distortions;

(c) to increase the mobility of labour and capital, particularly between the public and private sectors of the economy;

(d) to improve the flow of information to the private sector of the economy so as to reduce instability arising from business decisions based on incorrect or incomplete information;

(e) to deal specifically with "cost-push" inflation;

(f) to help ensure that the costs imposed on individuals by economic instability which it has not been possible to remove are borne equitably.

II. Techniques of Economic Stabilization

(1) Monetary policy, fiscal policy, and debt management have been less than adequately successful in the past because of insufficient co-ordination between them.

because of their being insufficiently flexible, because their implementation has resulted in unnecessary but significant disruptions to the smooth functioning of the capital market, because of uncertainty surrounding the direction which official policy has appeared to be taking, and because of the rigidity of certain institutional interest rates.

Recommended improvements in techniques in addition to the already mentioned formation of an economic stabilization committee or board are: changes in the Bank of Canada Act which would clearly indicate that the Minister of Finance acting for the Governor-in-Council is responsible for monetary policy at all times, as well as being responsible for fiscal, debt and exchange rate policies; improvement in the quantity, quality and timeliness of economic indicators; use of fiscal policy and debt management as a supplement to monetary policy in controlling the supply of money; improvements in the lines of communication between "Ottawa" and the capital market and in the market expertness of those implementing

stabilization policy; re-introduction of a "fixed" Bank Rate; removal of the ceiling on chartered bank lending rates; more detailed reporting of central bank operations and decisions.

It is our view that additional techniques for controlling bank cash, such as a system of special deposits are unnecessary; that additional controls for economic stabilization should not be imposed on non-bank financial intermediaries; that any further separation of decision-making relating to monetary and debt management should be avoided; and that the Bank of Canada should continue to function as a separate entity and not as part of a department of government.

(2) Supplementary techniques should be available to influence, if necessary, the particularly volatile sectors of business capital spending and spending on consumer durable goods; variable depreciation allowances should be used with flexibility; and means should be found to vary down-payment and repayment provisions of consumer credit contracts.

(3) The Government of Canada should take the initiative in encouraging provinces to adopt anti-cyclical capital spending plans.

(4) Business should be supplied with improved statistical information relating to the state of industrial capacity and the behaviour of inventories.

(5) The proposed economic stabilization board should develop statistical data which would serve as guide lines to wage settlements and pricing policies in industries whether adequate competition on one or both sides of the bargaining table is absent.

PART TWO

FUNCTIONING OF THE CAPITAL MARKET

The basis of the functioning of the capital market should continue to be the inter-play of competitive forces. Obstacles to effective competition should be removed. Solutions to market deficiencies should, if possible, be of a kind which improve rather than supplant the operation of the market.

(1) It is possible that competition over the long-run period would be improved if banks were prohibited from holding more than a nominal amount of the equity of particular trust companies, and if directors of trust companies were precluded from becoming directors of chartered banks.

Amalgamations and mergers between smaller financial institutions should be permitted but not those which increase the share of the market of the already very large institutions.

(2) Minimum standards of the "jobbing" performance of money market dealers should be raised, and measures should be taken to ensure that credits utilizing the facilities of the short-term money market are scrutinized as closely as are customers of the chartered banks.

(3) Retaining ownership of Canadian industry in Canada might be enhanced if the investment policies of life insurance companies were more venturesome, and perhaps if the capital available for underwriting was increased. Term lending by banks should not be discouraged and debt and equity financing should be placed on an equal basis as far as income taxes are concerned.

(4) Fiscal difficulties of municipalities should not be remedied by changes in the capital market. A system of credit rating for municipalities should seriously be considered.

(5) Government credit institutions should be required to make available information which would enable an "outsider" to judge whether or not they are fulfilling their originally assigned role.

(6) The Canadian Bankers' Association, the Investment Dealers' Association and the Dominion Mortgage and Investments Association should expand their activities to include a continuing appraisal of alleged deficiencies in the capital market and should encourage the adoption of remedial measures.

Yours sincerely,

E. P. Neufeld.

PART ONE

THE PROBLEM OF ECONOMIC INSTABILITY

The problem of instability in Canada's rate of economic growth and general level of prices is neither transitory nor short-run; its presence has been statistically documented for a period covering many decades and there is little doubt that it has adversely affected the country's long-run rate of economic performance. It cannot be disputed therefore that a determined effort to improve our ability to cope with the problem is fully justified. It is within this context that the role and operation of the Bank of Canada must be discussed.

I. The Tasks of Economic Stabilization Policy

Before it is possible to make useful suggestions for improving our control techniques it is necessary to form rather specific views on (1) the objectives to be sought and (2) the nature of the problem of economic instability, and (3) the specific tasks of stabilization policy.

(1) Objectives of Economic Stabilization

There is now general agreement that the objectives of stabilization policy should be to maintain relative full employment, to ensure adequate stability in the general level of prices, and to permit, indeed encourage, the economy to expand at a maximum sustainable rate of economic growth. There is no general agreement as to the numerical interpretation

(1) Objectives of Economic Stabilization (cont'd)

of the words "relative", "adequate", and "maximum sustainable" that should be accepted by the policy maker. Disagreement in this respect, however, reflects less a varying social consciousness among those expressing an opinion on the matter than it does the absence of concrete evidence of the extent to which the aforementioned objectives can be achieved within the framework of a mixed free enterprise economy. We simply do not know what can be achieved.

It seems foolish therefore to present the policy maker with precise instructions as to the amount of unemployment that is tolerable, the degree of movement in the general level of prices that is acceptable, and the rate of economic growth which he should help to achieve. But there is every reason to expect the policy maker to explain in detail what he has done in attempting to achieve economic stability and to indicate how successful he has been, what problems he has encountered in attempting to fulfill his role, and where in his view further improvement lies. Only through persistent appraisal of the problems facing the

(1) Objectives of Economic Stabilization (cont'd)

policy maker, of the effectiveness of his control techniques and the success of his policies, will continuous improvement be made in meeting price, employment and output objectives. Continuous improvement cannot come from a once-for-all examination of the problems, techniques and policies, however thorough and incisive that examination may be. There is also great and obvious need for close cooperation and consultating on a continuing basis for reason of policy and policy implementation among the various government departments and the Bank of Canada - a point to which we shall refer again.

RECOMMENDATION:

The Government of Canada should establish a permanent economic stabilization board or committee composed of representatives from the relevant government departments and the Bank of Canada, and assisted by a permanent chairman and research staff, which should be responsible for appraising the problems of unemployment, inflation, and economic growth; for appraising the effectiveness of and planning the coordination between current monetary, fiscal (i. e. economic policies and programmes of all government departments), debt, and exchange rate policies; for seeking improvements in stabilization techniques and

policies; and for making recommendations to the government of the day. A detailed report of the work and findings of the board should annually be tabled in the House of Commons by the Minister of Finance.

One aspect of the objectives of economic policy is too often ignored, primarily because statements of objectives frequently appear to assume that full employment, price stability, and high economic growth can permanently be achieved if only appropriate policies are pursued. We have already suggested that only through persistent appraisal and improvement will we finally determine what can be accomplished in this respect. But for the present we must accept the fact that periodically not all people who wish to work will find work. If this is accepted, then what should be the objective of the policy maker?

We would suggest that in a certain sense involuntary unemployment is a cost of retaining the basic elements of the existing economic order. Because this cost falls heavily on a small portion of the working population, government policy should ensure that it is borne equitably.

Much, of course, is already being done to accomplish this objective, and we mention it here for two reasons: first, to emphasize that the objectives of economic stabilization must become more complex if it is assumed that desirable employment, price and growth objectives cannot always be met; second, to suggest that if the social costs and therefore political pressures of unemployment are minimized, the policy maker will enjoy increased freedom to pursue economically appropriate stabilization policy.

There is a final aspect to the matter of stabilization objectives which we would wish the Commission to consider: it is the relationship between those objectives and the techniques for achieving them. Certain control techniques are in basic disharmony with the functioning of the capital market (and other markets, for that matter), others are not. Stabilization control techniques which negate the operation of the free capital market lead logically to further controls designed to offset the ill-effects of the former. Whether or not one regards such proliferation of controls with equanimity will depend on one's over-all appraisal of and sympathy for a market-oriented economy, and this will vary from person to person. For the policy maker who is generally sympathetic with the view that a relatively free capital market should be perpetuated, there is therefore the additional policy objective of interfering as little as possible with that type of market. The foregoing leads us to the following general recommendation relating to the objectives of economic stabilization.

RECOMMENDATION:

Economic stabilization policy should have as its general objective the achievement of a low level of unemployment, a high rate of economic growth, relative price stability, and an equitable distribution of the costs which are inflicted on individuals by economic instability which it has not been possible to remove -- all within the framework of techniques which interfere as little as possible with the efficient functioning of the capital market.

(2) <u>Nature of Canada's Economic Instability</u>

It is intended here to confine our discussion to several aspects of the problem of economic instability which seem particularly relevant to our subsequent discussion of control techniques.

Some of our past business cycles have been mild, others have been severe. In most of them inventory accumulation, business capital spending, and consumer spending on durable goods have been volatile. The greater their volatility has been, the greater has been the volatility of output in general. A more sustained rate of economic growth we believe requires a more orderly expansion in those areas than has been the case in the past.

But it is difficult to prescribe for that instability before its nature is understood. We do not wish to review here the many theories of the business cycle which have been developed over the years, but do wish to suggest that businessmen may perhaps suddenly become unduly optimistic or pessimistic either because (a) their <u>correct</u> interpretation of current information and events leads them to believe <u>rightly</u> that sales and profits are likely to change substantially in future, or (b) their <u>incorrect</u>

(2) Nature of Canada's Economic Instability (cont'd) or incomplete interpretation of current information and events leads them to forecast incorrectly their sales and profit prospects. Because of the latter possibility economic stabilization, curiously enough, may include disseminating detailed and current information on markets, plant capacity, and inventory accumulation, as well as influencing the cost and availability of credit, the size of consumer spendable income, and the rate of spending in the public sector.

A further aspect of the business cycle which merits our attention is its varying intensity. If the cycle happens to be mild then it is possible that the all-pervasive effect of monetary policy and of that part of fiscal policy which affects private and public spending in a general way may be sufficient for achieving a tolerable degree of economic stability. But experience suggests that this may not be the case when the cycle becomes severe. In such a cycle many businessmen, for whatever reason, appear to become rather insensitive to interest-cost when planning their capital expenditure programmes; and consumers appear not to be

(2) Nature of Canada's Economic Instability (cont'd) influenced strongly by the cost of credit when contemplating purchases of durable goods. It is because of this aspect of the business cycle that control techniques aimed at particular volatile sectors may be necessary to supplement the aggregate techniques of monetary and fiscal policy.

Techniques which are designed to prevent particular sectors from becoming overly volatile are necessary not merely for controlling the business cycle but also for preventing sector distortions which in future cause trouble over a period longer than a business cycle. For example, the extreme investment "boom" of 1955 to 1957 resulted in two major distortions: over-investment in many industries, possibly leaving in its wake high unit overhead costs; and an excessive trade deficit. The latter was excessive not in the sense of frustrating our ability to control the business cycle, for the high level of imports proved to be a powerful anti-inflationary force, but rather in the sense that being accompanied by a rising premium on

(2) Nature of Canada's Economic Instability (cont'd)

the Canadian dollar it involved a relative shift of resources out of the export and import-competing industries which was not sustainable once the excessive expansion was over. In other words, the transitional economic costs of first shifting resources massively in one direction and then painfully (as our slow growth rate since 1957 attests) back again probably were heavy.

It is not likely that all sector distortions will always be avoided. The mobility of labour and of capital should therefore not be impeded and perhaps should be enhanced. But since the major distortion during "boom" periods is likely to be excessive expansion in the private sector, a solution to the problem in the subsequent period of recession will involve a "catching up" of the public sector. It is for this reason that greater co-ordination between the federal government and the provincial governments on capital spending plans has become necessary.

Both the intensity and the structure of the business cycle are difficult, if not impossible, to forecast. The policy maker is given little warning

(2) Nature of Canada's Economic Instability (cont'd) as to whether it will be mild or intense and as to which sector or sectors will prove particularly troublesome. This makes it essential that the aggregate techniques of monetary policy and fiscal policy, and the techniques designed to supplement those policies in dealing with unusual volatility in particular sectors, must be used flexibly. In our view there are few obstacles in the way of the flexible use of monetary and aggregate fiscal policy, but there are in the use of supplementary control techniques. These we discuss below.

One remaining aspect of economic instability to which we wish to refer is the matter of "cost-push" inflation, that is inflation which arises because of administrative increases in prices of goods and wages made possible by monopoly elements and made permanent by monetary expansion as soon as those price increases or other factors begin to create unemployment. Virtually all our stabilization techniques are designed to counter "demand" inflation, that is "excess spending" inflation; none to counter "cost" inflation.

(2) <u>Nature of Canada's Economic Instability</u> (cont'd)

There is no general agreement as to the relative importance of "cost" inflation in a comprehensive explanation of increases in the general level of prices. The problem is too complex for existing tools of statistical measurement to be able to provide answers which would enjoy general agreement among informed observers. This difficulty is not likely soon to disappear. For that reason we believe that the only practical approach remaining is to assume that "cost" inflation has become sufficiently important to warrant an attempt to design techniques for dealing with it. If this is not done there is a danger that "demand" inflation techniques will be used to counter "cost" inflation with the end result of increased and excessive unemployment accompanying the attempt to stabilize the price level. The conflict between the objectives of low unemployment and price stability may require the development of control techniques designed to cope with "cost" inflation.

(3) Specific Tasks of Stabilization Policy

From the foregoing discussion of the objectives which stabilization policy should seek to achieve and of the character of economic instability, we are able to summarize the specific tasks which we believe stabilization policy faces:

(a) to control cyclical spending in the private sector in general;

(b) to ensure that particular sectors do not become so volatile as to produce harmful economic distortions;

(c) to increase the mobility of productive factors, particularly between the private and the public sectors of the economy;

(d) to improve the flow of information to the private sector so as to reduce instability arising from business decisions based on incorrect or incomplete information;

(e) to deal specifically with "cost-push" inflation;

(3) Specific Tasks of Stabilization Policy (cont'd)

(f) to help ensure that the costs imposed on individuals by any economic instability which it has not been possible to remove are borne equitably.

We turn now to a discussion of the techniques which are required for executing the aforementioned tasks of economic stabilization.

II. Techniques of Economic Stabilization

We intend in this section of our Submission to discuss the deficiencies of our existing control techniques and the improvements we believe should be adopted. In order to show clearly the relationship between this discussion and that of the preceding section, we will discuss these deficiencies in relation to each of the specific stabilization tasks which have already been outlined.

(1) Techniques for controlling cyclical spending in general in the private sector

Monetary and fiscal policies are now, and no doubt will remain in future, the principal means available for influencing the general level of spending in the private sector of the economy. They can have an all-pervasive influence on the cost and availability of credit, on the rate of exchange, and on the amount of spendable income left in the hands of individuals and businesses. Expertness in the use

of those techniques is not yet what it might be, but it is to be remembered that their conscious and determined use has a very short history -- in our view not more than a decade -- and is likely to improve with further experience. They have the virtue that they interfere less with markets than do more selective and more direct types of control. Thought of replacing them with other controls in a market-oriented economy can be little more than idle speculation. They have to be made to function reasonably well, the alternative being a major move away from our market-oriented economy or an acceptance of cyclical instability of past magnitudes.

(a) Lack of Co-ordination

In our view a major deficiency of past use of aggregate monetary and fiscal policy, and also debt management, has been a lack of co-ordination between them. There have been times when the management of the public debt has interfered substantially with control of the supply of money. There have been times in the last five years when monetary policy has negated part of the desirable effects of deficit spending, although this cannot

be said for the period since June 1961. The possibility of conflict in objectives makes co-ordination essential.

But in addition, the nature of the technical relationship between monetary, debt, and fiscal policies is such that co-ordination is essential on operational grounds as well. Fiscal policy can influence the supply of money by varying the amount of idle government cash balances; efficient debt management involves purchases and sales of securities by the central bank and also involves close scrutiny of markets by the central bank; and no Minister of Finance can safely embark on an expansionary budget policy unless he is assured of accommodating policy at the central bank. Institutional arrangements therefore should be such as to ensure that co-ordination of policy objectives and of implementation of policy will be complete.

RECOMMENDATION:

The Minister of Finance acting for the Governor-in-Council should unequivocably be responsible for all aspects of economic stabilization policy -- monetary, fiscal, debt, and exchange rate. Since confusion over this line of responsibility has existed only in relation to monetary

policy, it is recommended that the Bank of Canada Act be amended to give the Minister of Finance authority to issue directives to the Bank of Canada. The Bank of Canada Act should also be amended to make the appointment of Governor "at the pleasure of the Governor-in-Council", as well as for a fixed period of time, but with the added provision that when a Governor is removed or his appointment is not renewed he be given the opportunity to appear before both the Senate and House of Commons Banking and Commerce Committees before the expiration of his appointment.

In an operational sense co-ordination of objectives and of the implementation of policy should be assured through the regular and frequent meetings of the already mentioned economic stabilization board or committee.

(b) Lack of Flexibility

Both monetary and fiscal policy at present are insufficiently flexible. This is a severe deficiency. Economic forecasting is still so crude that it cannot give the policy maker much warning of changes in the rate of economic expansion and contraction, with the result that policy may have to be reversed on very short notice. Improvement in the timing of policy changes can come through improvement in our statistical data.

RECOMMENDATION:

The Government of Canada should devote sufficient resources to the compilation of current statistical series, including business cycle indicators, so that they are available to the policy makers and the general

public as quickly as are the indicators in the United States. The quality of some existing indicators should be improved.

Monetary policy has been too inflexible in the sense that the range between monetary ease and monetary restriction within which it has operated over the business cycle has been too narrow. The fact that no one knows what constitutes the "right" supply of money at any given moment may lead to an overly cautious policy. This problem would be reduced if the central bank felt confident that mistakes could easily be remedied. The fear that substantial monetary expansion during recession will be difficult to offset during a subsequent period of potential inflation seems in part to have been responsible for timidity in the use of monetary policy until recently. That fear, under present institutional arrangements is partly justified. To attempt to reduce substantially the supply of money during periods of inflation through ordinary central banking techniques -- which are techniques which operate largely through the narrow channel of the securities market -- would impose a strain on the financial markets reminiscent of the "financial crises" in the New York market of past decades.

But the problem could be solved by the Government of Canada building up a cash surplus during periods of inflation and leaving that surplus idle on deposit with the chartered banks. This is not only a matter of surplus budgeting; it is also a matter of disposition of the surplus. Disposition in the way suggested would in effect constitute a reduction in the supply of money; it would result in fiscal policy reducing not only

disposable income but general public liquidity as well. Such an arrangement would permit the Bank of Canada to act more decisively during a recession than it has been able to do in the past. Through its control of the supply of money the Bank of Canada could concentrate on creating interest rate levels which it regarded as appropriate for the economic circumstances of the time; while at the same time the budget would be rendering decisive assistance to monetary policy in controlling the stock of liquid assets of the public. Comprehensive aggregate stabilization policy must include control of the cost of credit and of the stock of liquid assets.

RECOMMENDATION:

During a period of threatening demand inflation a policy of credit restraint on the part of the Bank of Canada should be accompanied by a policy of liquidity restriction on the part of the Government of Canada through accumulation of idle government balances with the chartered banks. During a period of unemployment a policy of credit ease on the part of the Bank of Canada should be accompanied by a policy of liquidity expansion on the part of the Government of Canada through the latter financing its deficit at least in part out of previously accumulated cash balances.

It is our view that the facilities available to the Bank of Canada for controlling bank cash through open market operations and through shifting Government of Canada funds between the Bank of Canada and the chartered banks are adequate for central bank cash management.

The use of techniques such as variable cash reserve ratios would, in the Canadian institutional arrangement, be a warning that unusual forces are tampering with prudent cash management. We see no reason for adding to such techniques, in the form of a system of "special deposits". Nor do we feel that any system of selective credit controls should be the responsibility of the central bank.

(c) Undesirable Impact on the Capital Market

There have been occasions when the operations of the Bank of Canada in its role of money manager and of agent of the government for the management of the public debt have created undesirable confusion and uncertainty in the financial markets. It is not our view that a solution to this problem lies in confining the Bank of Canada to one part of the financial market -- for example, the short-term market, or in establishing yet another authority, this one for managing the public debt. We believe it lies in improving the lines of communication between the market and those responsible for monetary and debt management, and in making it possible for the Department of Finance and the Bank of Canada to recruit and retain personnel whose technical competence in trading and in the new issues market compares favourably with any in the bond houses. There are various ways that this might be done and no specific recommendation will be suggested. But the possibilities that might be examined are (1) one Deputy Governor of the Bank of Canada might always

be appointed from the executive ranks of the financial institutions for a period of three to five years without being eligible for re-appointment except to another position in the Bank; (2) the Bank of Canada might assign more senior representatives to Toronto and Montreal with more authority in trading than is now the case; (3) the Board of the Bank of Canada might include more members with financial and economic experience than is now the case; (4) the Government of Canada might request the financial institutions to form a permanent advisory board which it could consult whenever this seemed desirable.

One aspect of the relationship between Bank of Canada, government, and financial market is worthy of special attention. It is sometimes suggested that the Bank of Canada, since its policy must be government policy, should become a department of government or a part of the Department of Finance. We disagree. It is our view that the success of the Bank of Canada in its money and debt management operations will depend to a significant degree on the extent to which it can become a <u>market</u> institution as well as an institution of economic policy. This, in our view, is more likely to be the case if it operates as a separate entity than if it does not.

It is our view that one of the reasons why central bank policy and operations are not widely understood and occasionally somewhat emotionally misunderstood, is the Bank of Canada's reluctance to discuss the rationale of its operations and its policy, or even to announce what its major policy decisions have been. It should be possible for the Bank of Canada to be more forthcoming in this respect without jeopardizing its role as money and debt manager, without violating its subsidiary relationship with the government of the day, and without raising controversies which are not obviously related to central banking. Such a procedure, we believe, might also provide a solution to the perennial complaint of central bankers that the public expects too much from monetary policy.

(d) <u>The "floating" Bank Rate</u>

The financial operations of the Government of Canada and the Bank of Canada are now so large and so influential that they can have a decisive, sometimes devasting effect on the smooth functioning of the capital market. It is not idle curiosity which leads the banks, bond dealers, and even other financial institutions to examine most carefully the weekly statistics of the Bank of Canada and the statistics relating to the financial position of the Government of Canada.

Constant reassurance as to the basic direction of official policy is necessary. This reassurance can be given to a degree by a fixed Bank Rate, whereas a floating rate is virtually meaningless. The fixed Bank Rate is also a technique which on occasion can be used to influence market expectations in an economically stabilizing manner; if for example, a sudden increase in interest rates is necessary because of an unexpected change in economic conditions, a decisive increase in Bank Rate will harness expectations to bring about the desired effect, an effect which in subsequent weeks can be made permanent by a persistent policy of cash restraint. A change in a fixed Bank Rate may also in time induce some of the rather rigid institutional interest rates, such as the chartered banks savings deposit rate, to become more flexible. Public discussion of monetary policy which in the past followed a change in Bank Rate was not always constructive, but we believe that it would become more constructive as time went on. It is not our view that a fixed Bank Rate is a major technique of central banking. Nonetheless, it is our view that the effectiveness of the central bank would be enhanced if it made use of that technique.

RECOMMENDATION:

The Bank of Canada should revert to the practice of announcing a fixed Bank Rate.

(e) The 6% Ceiling on Chartered Bank Loan Rates

A ceiling on loan rates is justified if it is felt that the financial institutions involved enjoy a monopoly or if it is thought that the borrower must be protected against his own folly. When the ceiling is so low that it at times fails to reflect the true demand and supply forces in the capital market then it leads to distortions in lending which are difficult to justify. In addition, if it results in depositors being paid a relatively low return on their funds, it also encourages a movement out of savings deposit balances and in that way reduces the effectiveness of monetary policy. The interests of the borrower would be satisfied if he was made aware of the costs of funds supplied to him -- providing of course that he is not faced with a monopoly lender. These are the principal considerations leading us to the following recommendation:

RECOMMENDATION:

The 6% ceiling on chartered bank loans should be removed and the borrower's copy of the loan contract or promissory note should bear the simple annual rate of interest, to the nearest percent, being charged. In addition, the Canadian Bankers' Association should play no part in the determination of the prime loan rate or savings deposit rates. Informa-

tion on rates being charged and paid should be reported in convenient form to the Inspector-General of Banks.

(f) The Control of Non-Bank Financial Intermediaries

It has frequently been suggested that the powers of the Bank of Canada should be extended to include control over financial institutions other than the chartered banks because of the importance of those institutions in dispensing credit. We wish to discuss this issue at some length for its implications are important both for credit control and for the functioning of the institutions in the capital market.

Banks and non-bank financial institutions do not differ in that one can produce multiple expansion of credit and the other cannot; they both can do so. The banks can do so because they work to a cash/deposit ratio, provided they are given more cash by the central bank -- a side effect being an expansion in the supply of money, i. e. in deposit liabilities of the banks; and non-bank institutions might be thought of as doing so by working to some customary equity to debt ratio or liquid asset to liabilities ratio, and by increasing both the numerator and the denominator of that ratio by selling their equity or debt instruments to the general public -- a side effect being an increase in velocity of money, i. e. in chartered bank deposit liabilities.

They are also the same in that both can increase the velocity of medium of exchange by selling their more liquid assets to holders of cash balances and using the proceeds to make loans or purchase other securities.

The two differ in that the banks, in the absence of central bank control, could expand credit to the point where price inflation caused people to lose confidence in bank deposits i.e. the nation's money or medium of exchange; whereas non-bank financial intermediaries could profitably expand credit only so long as their cost of additional funds, which would increase as they attempted to sell more and more of their liability instruments (e.g. notes, debentures, time deposits), was below the return on new assets they acquired.

Control of the chartered banks, or any other financial institution whose liabilities constituted acceptable media of exchange, would be necessary even if there was no business cycle; control over non-bank financial intermediaries might be justified if it could be shown that existing monetary techniques operating on rates of interest were unable to narrow the spread between return on assets and cost of funds, or at least were unable to do so sufficiently quickly for anti-cyclical purposes.

It is our view that existing monetary control techniques can influence credit expansion of non-bank financial intermediaries. By causing interest rates to rise to the point where fewer and fewer borrowers find it profitable to borrow, the central bank can establish a ceiling on the return on new assets acquired by non-bank financial intermediaries; while any persistent attempt on the part of those financial intermediaries to seek more and more funds for lending will increase their cost of funds and this finally to the point where return on new assets and cost of new funds are such as to leave no room for additions to profits.

But does this process work sufficiently quickly for purposes of credit control? We believe it does in most cases provided the central bank influences interest rates with determination; many non-bank financial intermediaries have not shown volatile growth over the business cycle. It does appear as if some financial intermediaries have shown substantial expansion over certain past business cycles. A part of that expansion in the past has resulted from innovations in the capital market, such as the once-for-all development of the short-term money market, but such once-for-all developments do not justify added controls in future.

<u>Some of it we believe has resulted from the fact that the financial intermediaries involved may be catering to types of borrowers who for rational or irrational reasons are exceedingly insensitive to the cost of credit during periods of economic expansion, and not because those financial intermediaries are able to obtain large quantities of funds for relending without suffering significant increases in the rate of interest they have to pay</u>. To impose controls on those financial institutions would not get at the root of the trouble which is the insensitivity of their customers to rates of interest, and would merely drive those customers elsewhere for the funds they feel they must have. The solution to the problem we feel lies in influencing directly those sectors which tend to be insensitive to rates of interest, and emergency techniques for this purpose we discuss in the next subsection of this Submission.

While statistical data which we would wish to have in order to form a final view on the issue discussed above, is not available, we wish to emphasize that logic alone does not lead to the conclusion that non-bank financial intermediaries should directly be controlled for anti-cyclical purposes, and whatever evidence we have seen leads us to believe that they should not be so controlled. We would therefore recommend the following:

RECOMMENDATION:

Direct controls for purposes of economic stabilization should not be imposed on those non-bank financial intermediaries whose liability instruments do not to any significant degree constitute media of exchange.

(2) Techniques for controlling particularly volatile spending sectors of the economy

In an earlier part of this Submission we suggested that there have been times when business capital spending and consumer spending on durable goods have been unusually volatile over the business cycle and that such volatility may reflect an insensitivity to interest rates under certain economic circumstances. If this is a correct interpretation of the facts then we should have control techniques which would supplement interest rates in influencing the return which businessmen expect to obtain from new capital expenditures, and supplement the interest deterrent to excessive demand for consumer credit. We wish to emphasize that such emergency techniques should remain supplementary to aggregate monetary and fiscal policy for we do not expect that they would be required in every business cycle; but also, we believe that they should be available at short notice because of the unpredictability of the unfolding nature of the business cycle and economic growth.

Of the various techniques that might be considered we believe that the most effective and most suitable one for exercising a supplementary influence on business capital spending is flexible variation of depreciation allowances on new investment in terms both of the length of the write-off period and of the proportion of the total cost that can be written off; and the most effective one for exercising a supplementary influence on consumer spending on durable goods is variation of down-payment and period-of-repayment requirements.

RECOMMENDATION:

Variation of depreciation allowances for purposes of computing federal income tax liabilities should be put on a statutory basis in a way which would permit their flexible use by the Minister of Finance for anti-cyclical purposes; and if possible ways and means should be found to vary down-payment and repayment provisions of all consumer credit contracts in an anti-cyclical manner.

(3) Techniques for increasing the mobility of labour and capital between the public and private sectors of the economy

Earlier in this submission we referred to the fact that some economic instability is likely to remain in the private sector of the economy even after the conscientious use of stabilization techniques, and that as long

as this is the case it will be desirable for resources to move in and out of the public sector of the economy in a cyclically stabilizing manner. We believe that fiscal policy of the federal government alone is insufficient to effect the required shift, that frequently the highly productive social capital projects are ones for which the provinces and municipalities are financially responsible. It is our view that improvement in the anti-cyclical use of capital expenditures in the public sector requires co-ordination of such spending of all levels of government, and that this is possible within the framework of a federal constitution. There is evidence that some provincial authorities are not averse to the concept of cyclical budgeting, and given leadership in the matter by the federal government there is a reasonable hope that through co-operation and consultation alone, the rate of capital spending which is under the control of the provinces could more effectively be varied for stabilization purposes than has been the case in the past.

RECOMMENDATION:

The Government of Canada should take the initiative in developing lines of communication between it and the provinces which would permit continuous consultation and co-operation with respect to appraising the social capital needs of the nation and the planning and execution of public capital expenditure programmes.

(4) Techniques for improving the flow of information to the private sector of the economy so as to reduce instability arising from business decisions based on incorrect or incomplete information

There are two areas where additional information would, we believe, be useful for this purpose: the size of productive capacity in industry, and the nature of behaviour of inventories. It is possible that periodic construction of excess capacity would be dampened if at all times there was general awareness of the existing state of capacity in industry and if from the earlier stages of cyclical expansion capital spending intentions were related to changing industrial capacity. The statistical difficulties in compiling the information are great; nonetheless we would recommend the following:

RECOMMENDATION:

The Government of Canada should make it possible for the Dominion Bureau of Statistics and the Department of Trade and Commerce to attempt to expand the annual survey of investment intentions to include an annual survey of utilization of productive capacity.

Instability in the behaviour of inventories may arise in part because individual businessmen are insufficiently aware of the movements in their own inventories and because individual businessmen are insufficiently aware of the behaviour of inventories in their industry as a

whole. Techniques for inventory management at the company level have improved greatly in recent years, but they could be adopted more widely than appears to be the case at present; and seasonally adjusted series of inventories on the industry level might be extended to cover more industries and might be published more quickly than is now the case.

RECOMMENDATION:

The Government of Canada, probably through the Department of Trade and Commerce, should take positive steps to encourage wide adoption of formal inventory control measures at the company level; and should improve the statistical documentation of inventory behaviour on the industry level.

(5) Techniques for dealing specifically with "cost-push" inflation

RECOMMENDATION:

The proposed economic stabilization board or committee should develop statistics on labour productivity and product prices which could serve as guides to wage settlements and pricing policies in industries where it seems likely that monopoly elements are significant on one or both sides of the bargaining table.

It is quite possible that experience would show that further steps would need to be taken to meet the problem, but this would appear to us to constitute a reasonable starting point.

(6) Techniques for ensuring that the cost imposed on individuals by economic instability which it has not been possible to remove are spread equitably throughout the economy.

The principal contribution of the policy maker in this respect must come from the "built-in stabilizers" of fiscal policy, of which unemployment insurance is the most important. It does not appear that additional techniques of a cyclically stabilizing character which also serve the above mentioned purpose are readily available, and if it is found that this purpose is not sufficiently being served an extended use of existing techniques would probably prove to be adequate.

PART TWO

FUNCTIONING OF THE CAPITAL MARKET

It would be difficult to over-emphasize the importance to a market-oriented economy of a freely and efficiently functioning capital market. In a very real sense of the word the capital market lies at the heart of such an economy because of its role in allocating the nation's capital to various and competing uses.

Our capital market is by no means without deficiences. What one's reaction is to such deficiences, what solutions one attempts to devise for improving the functioning of the capital market will no doubt be influenced by one's over-all impression of the performance of the market as compared with the likely performance of other systems for allocating the nation's capital.

Our own general impression is that much of the capital market functions smoothly and relatively efficiently. Where there are deficiencies two types of solutions should be considered: those which remove the deficiency by removing the obstacles which interfere with the smooth functioning of the market; and in cases where that is not possible, those which supplant the operation of the market in particular areas, through the introduction of government credit institutions or the introduction of regulations affecting the operations of private credit institutions. It is also our view that the former solution should be given serious consideration before the latter is resorted to, since we believe

that while our capital market has undergone and is undergoing substantial change, it should and will to a very substantial degree continue to be based on the inter-play of competitive forces.

In this section of our submission we shall be concerned with a number of specific issues relating to the functioning of the capital market in general. The issues discussed are not always related to each other; nor do they by any means constitute a comprehensive list of the "problem" areas of the capital market. They are merely issues which we happen to have encountered and upon which we have views which might be of interest to the Commission.

The problems that will be discussed are not ones about which we feel we are competent to make definite recommendations, and therefore we prefer to leave our views in the form of "suggestions".

(1) <u>Competition</u>

The history of the development of the Canadian capital market reveals a number of examples where new and more efficient capital market institutions have proved to be the decisive competitors of existing and less efficient ones. Effective competition is desirable not merely for helping to maintain efficiency among existing companies in the capital market, but also for encouraging the further development of the market. Therefore market practices, institutional arrangements, and legislative restraints which dampen this

> competition not only reduce the spur to efficiency among existing companies operating in the capital market, but also reduce the rate of improvement of the capital market over time.

The relationship between some banks and some trust companies, through equity ownership and directorships, is very close. This relationship is a respectable one in the sense that it has existed virtually, but not quite, since the beginning of the formation of trust companies in Canada. What has changed is that the trust companies have in recent years become more venturesome. Some of this venturesomeness has taken the form of competition with the banks and in several cases even with the mutual funds. We enthusiastically endorse this development and hope it will go further.

There is, however, the question whether the close ties between banks and trust companies which were largely formed under quite different conditions -- including less concentration in banking -- are desirable under present conditions. We believe that a case could be made for prohibiting the banks from owning more than a nominal amount of the equity of a particular trust company, and for prohibiting directors of trust companies from also being directors of the chartered banks. Conditions should be such as to enable trust companies over the span of years to become even more competitive with banks and other financial institutions than is now the case.

There is also the matter of amalgamations and mergers in the capital market. Again the history of Canada's capital market provides some key to desirable developments in future. There is some evidence that the most efficient size of a given financial intermediary is likely to be one which constitutes a significant portion -- perhaps in the area of 20% -- of the combined size of all financial institutions of that type. In some cases the pattern of historical development has been a great proliferation of companies when a new type of institution first appears and then a persistent decline in the number of companies or in the number of companies which account for a large part of the total size of institutions of a particular type. It would, therefore, be a mistake to regard all mergers and amalgamations as undesirable.

For example, it does not appear to us to be in the public interest for the largest chartered banks to be permitted to amalgamate with other chartered banks, but an amalgamation between the very small chartered banks might be desirable. Also, we believe that further amalgamations among trust companies would not be undesirable, although whether such amalgamations should involve the several very large trust companies is another matter. In general we suggest that a distinction should be made between amalgamations which increase further the share of the market of the large financial institutions and those which do not. It is perhaps desirable and possible to devise formulae which would prevent the former without prohibiting

the latter, even though this would involve co-operation between the federal and provincial authorities.

(2) The Short-Term Money Market

In a relatively few years the short-term money market in Canada has grown substantially in the volume of business it does and in the variety of paper it handles. There are only two aspects of this development to which we wish to refer: the number of bond dealers in the market, and the scrutiny of the paper which comes into the market.

While the market has grown substantially its size would still not really seem to justify the relatively large number of dealers that are members of it. We, however, do not believe that the number should artificially be restricted. But it may be that if all the money market dealers were required to meet higher minimum standards in their role of "jobbers" of money market instruments that the matter would take care of itself. We wonder therefore whether the Bank of Canada should not restrict its "repurchase" facilities to those dealers that fulfill adequately their role of "jobbers" in money market securities.

Historically short-term loans in Canada have come from the chartered banks. Now through the growing importance of finance company and commercial paper some of them also come from the money market. Over the years the

banks have come to develop techniques for scrutinizing closely the credits which they approve. We wonder whether this is happening to the credits approved by the money market dealers or by the investors in money market instruments. It appears that in some cases substantial reliance is placed on the short-term borrower having an unused line of credit with a bank -- a line of credit which under conditions of restraint might suddenly become precarious. Several defaults in the redemption of short-term paper might result in a severe set-back to the further development of the money market.

It may therefore be desirable for requiring all recognized money market dealers to outline their procedures for appraising credit risks before they are granted borrowing facilities by the Bank of Canada. In addition, while we do not wish to discuss formation of a market in bankers' acceptances, we do believe that such a market among other things would result in money market instruments receiving closer scrutiny than appears now to be the case.

(3) Equity Ownership in Canada

It is sometimes suggested that the reason why Canadian companies have drifted into foreign ownership is because

Canada has insufficient capital of that kind. We disagree. We suspect it is in part because of the overly-conservative investment practices of our institutional investors, particularly our life insurance companies, and perhaps also because of inadequate capital of Canadian underwriting houses as a group.

Taking the first point first, we wonder whether almost a century of supervision by the Department of Insurance, coupled with the distorting views on investment values created by the depression of the 1930's have not resulted in a serious decline in the venturesome character of life insurance investment practices. Is it possible that the end result of those institutions operating under the cautious eye of the government supervisor and of knowing that mistakes will to some extent appear for all to see in published returns, is that the the investment boards of such companies have finally become more cautious than the official supervisors? We do not know, but suggest that ways should be found to make it respectable for life insurance companies to take greater risks than they now do, and to make individual investment mistakes which, while known to the Departments of Insurance, are not as a matter of course made known to the world at large through official publications.

It is virtually impossible for an "outsider" to appraise the adequacy of the capital of Canada's underwriting houses as a group. If it was inadequate one result would be for them to be rather more cautious in assuming risky underwriting liabilities than if it was not. For example, to offer the stock of a new public company to Canadians instead of permitting old established private companies from being sold to foreign investors, might require the underwriters to retain a significant portion of the stock for an extended period of time. This is possible only if the underwriters have sufficient capital. It may, therefore, be that the operation of the capital market would be improved if say, Canadian life insurance companies were permitted to assume underwriting liabilities in Canada. Some Canadian life companies already, in effect, assume such liabilities in the City of London, England.

This may also be the appropriate place to refer to the occasional practice of the chartered banks to engage in term lending. Such lending has several times suffered the disapproval of the Bank of Canada. We would suggest that as a

matter of long-run practice it is highly desirable. In special cases it is the most efficient way for capital to be raised; at the same time bank assets are so large and the banks have such a high proportion of savings deposits in their liabilities that they can make loans of that kind without any significant impairment of their financial soundness.

There is also the matter of the flow of new equity issues. Tax laws discourage companies from raising funds through the sale of stock, and encourage them to finance through the sale of debt. Yet there is no obvious reason why such distortion is necessary or desirable. It is possible that an improvement would be for neither interest nor dividends to be a deductible expense for income tax purposes and for the resulting increase in the burden of taxation to be neutralized by an offsetting reduction in the rate of corporation income tax.

(4) Municipal Debenture Financing

Considerable concern has been expressed over the adequacy with which the financial markets are providing municipalities with the funds they require. In our view it would be a mistake to assume too readily

that an inadequacy of funds was the result of the malfunctioning of private capital market institutions, although we do wish to refer to at least one possible problem of that kind. The basic difficulty may be the reluctance on the part of at least some municipalities to raise tax rates to levels which reflect the services demanded by their taxpayers; and the inadequacy of municipal taxing powers. It would, in our view, be a mistake to attempt to devise new institutions or investment practices for remedying what is essentially a problem of fiscal policy.

At the same time we have gained the impression that investment practices of some existing institutional investors are based on rules-of-thumb which no longer are relevant. How long must a municipality which experienced a bond default in the 1930's as a result of economic forces over which it had no control, pay for its "sins"? Also, is there not a tendency for rates on smaller municipal issues to vary directly with the distance of those municipalities from Toronto and Montreal? A dispassionate appraisal of the credit rating of smaller municipalities would seem to have become desirable.

It is suggested therefore that the Investment Dealers' Association be encouraged to establish a rating system for municipal issues which would serve as a guide to the changing credit standing of municipalities.

The trend has been for provinces to assume some of the burden of municipal financing, by extending loans and grants to them, by guaranteeing municipal issues, and by assuming responsibility for some of the services traditionally provided by municipalities. There is nothing undesirable about this trend but it is possible that it could go too far. Municipal taxing powers and practices, as well as institutional investment practices and facilities for marketing municipal debenture issues should be such as to maintain an economically healthy and viable system of local government.

(5) Government Credit Institutions

As already mentioned it may on occasion be necessary to fill gaps in the capital market with new government-sponsored credit institutions. This raises the question as to the basis of operation of those institutions. It is possible to draw on historical experience to show that government credit institutions can easily change from their role of filling gaps to the one of supplanting or competing with already existing institutions -- through

advantages gained from enjoying a subsidized source of external funds and a tax-free source of internal funds. (With the growing importance of credit unions this can apply also to them.) It cannot be assumed that government sponsored credit institutions will always allocate funds in an economically efficient manner, and it cannot be assumed that if they do not this will be reflected in their present form of balance sheet.

It would seem desirable for such institutions to be required to develop accounting techniques, and to make information available to the interested public, which would permit an "outsider" to form a view on the adequacy with which they are fulfilling their originally intended role.

(6) Continuing Improvement in the Capital Market

The functioning of our capital market is likely to improve more quickly if deficiences which arise in it from time to time are quickly recognized and speedily dealt with. We are concerned with how little interest the Canadian Bankers' Association, the Investment Dealers' Association, and the Dominion Mortgage and Investments Association appear to show to this aspect of the health of the

market, in contrast to the admirable work they have done in other directions. Curiously enough greater interest of this kind has recently been shown by the Stock Exchanges, although the cynic would no doubt remark that this was because they have enjoyed and do enjoy the most room for improvement.

It might therefore be suggested to those Associations that either separately or in co-operation with each other they might begin to concern themselves with the operation in general of the capital market, and that they might express that concern by undertaking or sponsoring studies, on a continuing basis, aimed at improving the performance of the capital market. The costs involved are likely to be small, the rewards potentially very large.